Response of the Law Society to the Financial Reporting Council consultation on the new Stewardship Code

27/03/19

1. The Law Society is the professional body for solicitors in England and Wales, representing over 160,000 registered legal practitioners. It represents the profession to Parliament, Government and regulatory bodies in both the domestic and European arena and has a public interest in the reform of the law.

2. We welcome your work to update your Stewardship Code. This should bring it back in structure and approach with your latest (July 2018) UK Corporate Governance Code (**UKCGC**) and reflect evolutions in the governance debate over the last number of years. The political and business environment in which corporate governance and stewardship responsibilities rest has changed significantly from the more benign climate of 2012.

General Observations

3. It is vital that the UKCGC and the Stewardship Code are documents which fit together in an effective manner, forming part of the bedrock of the UK corporate governance landscape.

4. In many ways, to create and maintain a code for investor and other stakeholder stewardship is a significantly harder task than to create and maintain a corporate governance code for companies. Whether intended or not, a code on corporate governance can be treated as a rule book, whether on a comply or explain basis or otherwise: this is not the case for stewardship responsibilities.

5. Companies vary in their structure, management and approach and a healthy corporate governance landscape should (within reason) encourage such variety. In a similar way, investors and other stakeholders with stewardship responsibilities have many different investment mandates, engagement strategies and priorities.

6. Support for the principle of good stewardship in all of its manifestations is to be encouraged. The FRC's Stewardship Code was in need of being refreshed and revived, not least to ensure that stewardship responsibilities continue to progress. As we can now (subject to the passing of necessary legislation) expect to see the FRC's operations evolve into a newly created Audit, Reporting and Governance Authority (**ARGA**) with a clearly defined statutory remit, as proposed by Sir John Kingman and as welcomed by our government, it will be most beneficial for the FRC to pass on each of its corporate governance codes in an up-to-date form.

7. In many circumstances, the most effective regulator any company can have are its stakeholders, including those which make a decision to invest in its shares (or not). Investors may decide to increase, reduce or liquidate an investment for a variety of reasons, including investment performance, sectoral and jurisdictional risk, management quality and governance. Any such decision by a significant investor will have a direct influence upon share price, liquidity and (consequently) management remuneration through long term incentive plans and other similar incentivization arrangements.

8. It is possible to mandate a level of reporting required in relation to almost anything: outputs can be measured objectively. However, it is not possible to set out strict and standardized expectations as to how a company, any investor or any other person within the stakeholder matrix should think and behave. Each such person or organization has its own particular reasons for its decisions and not all will wish to share such reasons, even if to do so would not infringe any securities law. Many investors and other stakeholders will always be resistant to the publication of particular investment or other decisions made by it and the reasons behind any such decision.

9. Whilst, as noted above, it is possible to prescribe in law and/or any regulatory standard what a company and its management should or should not do and how a company should report,

it is much harder to require this in the same way of investors in respect of their investment decisions.

Asset owners, asset managers and service providers

10. The manner in which you have categorized that which is the responsibility of asset owners, asset managers and service providers is helpful. However, the section on service providers appears in the document as something of an afterthought and does not really fit with the main body of the code. It would be helpful if this could be referred to more effectively from other parts and perhaps referred to as a part 6, with some clear wording in paragraph 5 of the introduction to make it clear that signatory asset owners and asset managers are expected to address parts 1-5 and signatory service providers are expected to address part 6.

Specific response to certain questions

11. It is not the position of The Law Society to respond to each of the questions you have raised and we leave the consideration of certain matters to the investment and business community. However, ever-interested in delivering certainty and stability to business, we respond to those questions were there is a legal or regulatory element.

Q3. Do you support ‘apply and explain’ for the Principles and ‘comply or explain’ for the Provisions?

12. This represents a logical analysis – but given that meaningful application is the bedrock of any code, the distinction is insignificant. In almost all circumstances, the explanation is more important, and more revealing, than the application/compliance or absence thereof.

Q7. Do the proposed revisions to the Code and reporting requirements address the Kingman Review recommendations? Does the FRC require further powers to make the Code effective and, if so, what should those be?

13. Following the government's recently published response to the Kingman Review (which came after the publication of this FRC consultation) we are now likely to see control for the Stewardship Code and the UKCGC pass from the FRC to the new ARGA. In this revision, it must therefore be appropriate for the FRC to only propose changes which fit within the scope of its current powers: it will be for the ARGA to determine the issue for the future.

Q14. Should there be a mechanism for investors to escalate concerns about an investee company in confidence? What might the benefits be?

14. We do not consider that the Stewardship Code is the appropriate framework for a regime for concern escalation and any such structure which may be proposed by BEIS should be framed in primary legislation, cognizant of issues such as privilege and discoverability.

Q17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

15. We think that it continues to be appropriate for the FRC to maintain one UKCGC and one Stewardship Code. There is a risk of dilution if there are too many. However, whilst maintaining a single Stewardship Code, there must be a place for potential enhanced separate guidance and it is noteworthy that the FRC has effectively already followed this approach in relation to service providers.

Q18. Should the Stewardship Code focus on best practice expectations using a more traditional "comply or explain" format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

16. We do not consider that it would be appropriate for the FRC to set out its expectations of best practice: this should be left to the investor market to determine. We do not think that it would support the cause of good stewardship to impose a rigid approach. It is much better for the FRC to set out its code and for the investment community to then respond to it: the manner in which The London Stock Exchange has sought to raise standards of corporate governance on AIM during 2018 is a good example.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

17. As already noted, we think that it is vital for the UKCGC and the Stewardship Code to be codes which reflect one another: this does not, however, require replication of approach, other than in the high-level principles where the two codes should represent opposite sides of the same coin.

Conclusion

18. An updated Stewardship Code in the form presented by the FRC will bring its work in this area to an effective conclusion and will enable it to pass on a complete package to the new ARGA. Once the necessary legislation is passed and once the powers, priorities and workstreams are determined, that body may be given a different remit and may pursue different strategies to the FRC in supporting the relationships between companies, investors and other stakeholders. Of course, the work of Sir John Kingman has highlighted that a current principal difficulty with the Stewardship Code is not its content, but the lack of effective enforcement and the risk of it being little more than an engine for boilerplate reporting, which acts against the interests of good governance.